A new European approach to business failure and insolvency

A restructuring directive proposal

European Commission initiative

- Restructuring directive proposal 22nd November 2016 based on 2014 Recommendation on New Approach to Business Failure and Insolvency
- Europe 2020 strategy to foster economic recovery and sustainable growth
- Member States should put in place a framework that enables the efficient restructuring of viable enterprises in financial difficulty
- Minimum standards on preventive restructuring frameworks
- Currently EU only has Insolvency Regulation – 'recast' as Regulation 2015/848 which deals principally with cross border insolvency
- Deal with jurisdiction to open insolvency proceedings, choice of law, cross border recognition of the opening of insolvency proceedings and insolvency and related judgments
- Action plan on building a capital markets union
- Including harmonisation of elements of substantive insolvency law

Why the initiative?

- Jobs and growth – Juncker plan
- Fewer insolvencies and less dislocation in communities
- Reducing divergence in national insolvency frameworks
- Emergence of pan European equity and debt markets
- Difficulties in assessing credit risk in respect of cross-border investments
- Difficulties for minority creditors in forum shifting
- High costs for SMEs

Why a legislative initiative?

- Inconsistent implementation of the Recommendation
- But enough time to assess compliance?
- In some countries ‘modern’ restructuring procedures completely absent
- In others, cumbersome and inefficient transferring value to ‘out of the money’ creditors and shareholders
- Also prolonging the life of financially unviable companies and hindering objective of putting assets to most effective use
- But changes in some countries including France and Netherlands
- Learning from experience rather than top-down ‘blueprint’?

World Bank Doing Business project

- Some reliance on the World Bank (WB) resolving insolvency framework – www.doingbusiness.org
- In terms of efficiency of insolvency frameworks EU average is below that for OECD average for high income countries
- WB scores based on normative assessment of insolvency frameworks and guess-estimates of recovery rates by secured creditors in the insolvency of a particular country
- But drive to improve information gathering in 'recast' Insolvency Regulation
- Question marks about WB methodology – lack of correlation between WB scores and economic success - China

Conformity with international developments

- UNCITRAL Legislative Guide & World Bank principles
- Modern insolvency laws should promote restructuring of viable businesses
- Efficient closure and transfer of assets of failed businesses
- General conformity with Chapter 11 US Bankruptcy Code
- Some nod in the direction of UK schemes of arrangement
- But also differences in detail

Chapter 11 as a guide – main features

- No management displacement - management can prepare a restructuring plan and submit to creditors
- A court-appointed trustee may be appointed but it's powers are not as far-reaching as those under a management-displacement regime
- A moratorium exists to protect debtor from its creditors
- "Cram-down" provisions under which a class of creditors, including secured creditors, can be forced to accept a restructuring plan if the court determines at least one class of impaired creditors have accepted the plan and it is feasible
- Debtor-in-possession financing mechanism - may enjoy "super-priority" ahead of other creditors if existing creditors are deemed by the court to be adequately protected
- ABI report – possible Chapter 11 reforms – out of the money creditors getting redemption option value based on options pricing methodology – also different strokes for different folks

Main features of the Commission initiative

- The possibility to file early with the objective of avoiding insolvency
- The position of the debtor i.e. debtor-in-possession
- The possibility of a stay on individual enforcement actions
- Adoption of the restructuring plans by creditors
- Provisions on executory contracts
- The protection for new finance granted in restructuring procedures
- The involvement of courts when third party rights could be affected

Claim that the elements together will necessarily enhance the efficiency of restructuring procedures

Similarities with Chapter 11

- Debtor in possession norm
- Stay on claims against the debtor to facilitate the restructuring process
- Treatment of executory contracts
- Conditions for getting a restructuring plan approved
- Protection for new money finance
- Differences in detail - while Chapter 11 stay is automatic in its effects and global in its reach, the stay proposed is discretionary.
- Chapter 11 also contains a much more extensive new finance regime than is proposed under the Directive.

Early stage restructuring – UK similarities

- UK scheme of arrangement seems to be possible basis
- UK courts may approve schemes in respect of foreign, including EU, registered companies
- Courts may approve schemes in respect of foreign companies if the company is deemed to have sufficient connection with the UK and benefits to creditors such as recognition in other countries
- But scheme procedure outside 'old' and revised Insolvency Regulation
- Odd for Commission to rely on procedure that is not entitled to the benefit of automatic EU wide recognition?
- But scheme may be entitled to recognition under Jurisdiction and Judgments Regulation (Brussels 1) – not entirely clear
- Life of the law – not logic but experience

A political process

- Not a fully harmonised procedure – minimum rather than maximum harmonisation procedure
- Considerable discretion left to Member states – may even claim that existing national procedures are fully in conformity with the Directive
- Law is a cognitive institution – must be embraced by legal intermediaries
- Path dependency – role of existing legal norms in shaping legal developments
- Legal concepts behave differently in different countries
- Concept transplantation may have unintended consequences for the rest of the body of law in receiving country

Role of employees

- Political compromise at heart of US Chapter 11 process – GM and Chrysler restructurings
- In the past Chapter 11 used to rewrite collective bargaining agreements in ‘legacy’ industries
- Restructuring directive proposals without prejudice to employee information and consultation rights
- But employees may be placed in separate class and subject to cross class creditor cramdown

Debtor in possession

- Debtor should keep control over day-to-day business operations
- DIP norm possible appointment of a practitioner in the field of insolvency on a case by case basis where considered to be appropriate
- Member States may require such appointment where there is a general stay or where restructuring plan involves cross class creditor cramdown
- Also DIP norm counterbalanced by duties of directors set out in Art 18
- Headed "Duties of directors in connection with negotiations on a preventive restructuring plan"
- But sets down a series of European norms that apply more generally" where there is a likelihood of insolvency"

DIP 2 – Obligations of directors

- (a) to take immediate steps to minimise the loss for creditors, workers, shareholders and other stakeholders;
- (b) to have due regard to the interests of creditors and other stakeholders;
- (c) to take reasonable steps to avoid insolvency;
- (d) to avoid deliberate or grossly negligent conduct that threatens the viability of the business"

Proposed European norm is internally contradictory?

Stays or moratoria

- Article 6 refers to a stay of individual enforcement actions to the extent necessary to support negotiations on a restructuring plan
- States are required to put in place measures to allow for such a stay.
- Stay is not automatic nor necessarily comprehensive though may include secured and preferential creditors.
- Only exception is the outstanding claims of workers unless, and to the extent, Member States put in place alternative measure for the protection of such claims.
- Initial maximum duration of the stay is 4 months though the stay may be extended for a period or periods reaching a maximum duration of 12 months
- Stay intended to give debtor breathing space to negotiate a restructuring plan relief from the stay if affected parties can establish unfair prejudice to their rights or interests – ‘anti-commons’ problem
- Also lifting of the stay when it appears that negotiations on a restructuring are not likely to yield a plan that will get approved

Ongoing/executory contracts

- Article 7 obliges Member States to ensure that creditors may not withhold performance or terminate, accelerate or in any other way modify executory contracts to the detriment of the debtor during the stay period.
- Extends to creditors relying on contractual clause that provide for such measures, solely by reason of the debtor's entry into restructuring negotiations or requesting a stay of individual enforcement actions and to “any similar event connected to the stay”
- Wider provisions in US Bankruptcy Code s 365 allowing debtor to ‘cherrypick’ executory contracts

Ongoing/ executory contracts 2

- Not heralded to any greater extent in the earlier Commission Recommendation.
- Rec 10 provided that the stay should not “interfere with the performance of on-going contracts” but no other provisions
- Proposal is a much greater encroachment on freedom of contract.
- Not hedged about with some of the detail in US Bankruptcy Code
- Position of financial markets contracts and IP licenses
- Possible limitation to “essential contracts” produces uncertainty

Facilitating new financing

- Should be exempted from civil and criminal liability
- Not rendered invalid as an act detrimental to the general body of creditors.
- View that encouraging new financing is necessary to ensure success of a restructuring plan
- Dedicated regime often advocated to address ‘debt overhang’ and to cure ‘underinvestment problems’
- Nothing detailed like s 364 US Bankruptcy Code

Restructuring plans

- Proposal contains old Chapter 11 favourites such as cram-down of dissenting creditors, cross-class creditor cram-down and the “best interests of creditors” test. These features were hardly found at all in the earlier Recommendation
- Some issues left up for grabs and where Member States may take divergent views.
- In principle, each class of affected creditors must accept a restructuring plan before it may be approved by a judicial or administrative authority.
- If there is no unanimity within the class then the dissenting members of the class are said to be “crammed down”. The plan becomes binding on them even though they have not given their individual consent.

Restructuring plans 2

- At least four issues to be considered –
- class composition;
- how consent is to be determined;
- conditions for judicial or administrative approval
- further conditions to be satisfied in the event of a possible cross-class creditor cram-down

Class composition

- Ability to put creditors into separate classes may be crucial in the context of a contentious restructuring
- Facilitate ongoing negotiations over the division of the "going concern surplus" – the amount of "value" greater than liquidation value which a corporate restructuring is intended to preserve and enhance
- Proposed directive requires as a minimum that secured and unsecured creditors should be put in separate classes
- Employees may be put in a separate class of their own
- Classes are also required to be internally homogenous comprising the holders of "claims or interests with rights that are sufficiently similar to justify considering the members of the class a homogenous group with commonality of interest"
- No specific requirement that creditors connected to the debtor should be placed in a separate class

How consent within a class is to be determined

- Seems to import a pure value requirement rather than an alternative or additional numerosity requirement
- Numerosity requirements can generally be overcome by debt splitting and assignment though this process adds to delay and expense
- Less clear is whether the relevant majority is of all the creditors in the affected class or merely those voting
- Three possible scenarios - one approach - creditors not voting are deemed to have voted in favour of the plan.
- Another approach - those not voting are deemed to have voted against the plan
- Third approach disregards the votes of those not voting - seems the most sensible
- Up to Member States to stipulate the required majorities but stated this majority should not be higher than 75% in the amount of claims or interests in each class.

Conditions for judicial or administrative approval

- Consent of the necessary majority of creditors within the class and plan has been notified to all known creditors likely to be affected by it.
- Plan also required to comply with the' best interest of creditors test' and to pass a feasibility review.
- Article 2(9) defines the "best interest of creditors test" as meaning that no dissenting creditor should be worse off under the plan than in a liquidation of the business whether piecemeal or by a going concern sale.
- Strongly entrenched in US Chapter but an alternative is a creditor democracy approach

Conditions for judicial or administrative approval 2

- “Feasibility” review - Article 10(3) provides that Member States should ensure that a plan does not meet with judicial or administrative approval where it does not have a reasonable prospect of preventing the insolvency of the debtor and ensuring the viability of the business.
- Also found in the US Bankruptcy Code - s 1129(a)(11)
- Has the court the competence and experience to exercise the necessary level of commercial and economic judgement?
- But feasibility review envisaged under the proposed directive is relatively light touch

Further conditions for cross class creditor cramdown

- This means confirming a restructuring plan against the objections of one or more classes of affected creditors
- In US Chapter 11 but is not a traditional aspect of the European restructuring scene
- Apart from "best interests of creditors" test", creditors in Chapter 11 are protected by an extensive list of conditions in s 1129
- Plan must not discriminate unfairly and has to be fair and equitable
- For the secured creditors, this means effectively the payment of the amount secured in full over time
- Unsecured creditors protected by the absolute priority principle - shareholders cannot be paid before the creditors unless the creditors consent or the shareholders are providing some new or additional value
- Same applies to senior and junior creditors

Cross class creditor cramdown 2

- Rules in Europe superficially much simpler
- But may be problematic in practice and words in Article 11 also somewhat difficult to interpret.
- Absolute priority principle
- Also may require at least one "impaired" class of creditors should approve the plan
- Recital 28 preamble refers to a plan being "supported by at least one affected class of creditors and that dissenting classes are not unfairly prejudiced"
- Value of the enterprise on a restructured basis rather than on a liquidation value
- May mean less on the table for junior classes of creditors and shareholders

Cross class creditor cramdown 3

- Member States are urged to take measures that prevent equity holders from blocking a plan designed to restore the viability of the business.
- Equity holders may form a separate class or classes to vote on the plan but they have no veto and are subject to the standard cross-class cram-down mechanism
- Working out values is no easy task
- Article 13 obliges Member States to ensure that “properly qualified experts are appointed to assist the judicial or administrative authority, when necessary and appropriate, for the purposes of the valuation, including where a creditor challenges the value of the collateral”

Conclusion 1

- Reforming corporate restructuring law in Europe is a work in progress.
- Recast Insolvency Regulation was one step and restructuring directive proposal
- Proposal suggests a minimum harmonisation directive with a substantial measure of uniformity in respect of laws on corporate restructuring and “second chance” for individual entrepreneurs.
- Proposal does not suggest introduction of a fully harmonised procedure - “politically unfeasible and clearly disproportionate”.
- Political imperative behind some element of action - low growth rates and high levels of unemployment - a particular issue in some countries.
- Juncker plan emphasising jobs and growth and other policy pronouncements

Conclusion 2

- US Chapter 11 - served the "[US} nation very well—aiding in the economic recovery from the Great Recession—and that has become the envy of the world"
- Europe's answer to Chapter 11 but a work in progress rather than a fully finished product
- Proposal builds on earlier Commission Recommendation but some new aspects are new e.g. provisions on executory contracts - not fully "road tested"
- Level of detail in the proposal such as on cross class cram-down that was absent from earlier Recommendation
- Maybe these matters could do with adjustment and refinement
- Important to acknowledge limitations of corporate restructuring law
- Restructuring law, by itself, cannot mend a bad business model or lead to economic growth
- No end of history

Thank You

- Happy St Patricks Day!

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